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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1958

No. 827

BENJAMIN D. AND MADELINE PRENTICE GILBERT,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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STATUTE

Internal Revenue Code of 1939:

Section 23(k) 7, 8, 13
(4) 3

MISCELLANEOUS

"The Thin Incorporation Problem Today", Jay O. Kramer, *The Journal of Accountancy*, December, 1958, p. 48 *et seq.* 14
"Stockholder Loans: Thin Capitalization", Bryson, *Proc. of NYU 8th Annual Institute on Federal Taxation*, p. 732 17
"Capital Structure", Kumler, *Proc. of The Tax Institute, University of Southern California School of Law*, p. 181 17
"Thin Incorporations: Income Tax Advantages and Pitfalls", Schlesinger; 61 *Harvard Law Review*, p. 50 17

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"Nourishing the Thin Corporation", Spanbock, Carro and Katz, *Taxes, The Tax Magazine*, October, 1956, p. 687 17

"Thin Capitalization: Some Current Questions", Bittker, *Taxes, The Tax Magazine*, December, 1956, p. 830 17

Note, "Thin Capitalization and Tax Avoidance", 55 Columbia Law Review, p. 1054 17

"Current Trend in Guaranty Cases", Holzmann, 11 *Tax Law Review*, 29 17

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable The Chief Justice and Associate Justices of The Supreme Court of the United States:

Your petitioners, Benjamin D. and Madeline Prentice Gilbert, husband and wife, pray that a writ of *certiorari* issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this federal income tax case on January 14, 1959.

Opinions Below

Four prior opinions have been entered by courts in this case. There have been two appeals from Tax Court deci-

sions to the United States Court of Appeals for the Second Circuit. The first Findings of Fact and Opinion of the Tax Court was filed June 12, 1956 and is reported as T. C. Memo 1956-137 in Docket No. 49422. This Opinion is printed as Appendix B, *infra*, p. 20. The first Opinion of the United States Court of Appeals for the Second Circuit was filed on September 26, 1957 and is reported at 248 F. (2d) 399. It appears as Appendix C, *infra*, p. 34. Upon remand by the Circuit Court the Tax Court filed a Supplemental Memorandum Findings of Fact and Opinion on January 23, 1958, which is reported as T. C. Memo. 1958-8 in Docket No. 49422, and is printed as Appendix D, *infra*, p. 55. The second Opinion of the United States Court of Appeals for the Second Circuit was entered on January 14, 1959; it has not yet been printed in the official reports but is printed here as Appendix E, *infra*, p. 59.

Jurisdiction

Both the opinion and judgment of the United States Court of Appeals for the Second Circuit were entered on January 14, 1959. They appear, respectively, as Appendix E, *infra*, p. 59 and Appendix F, *infra*, p. 64. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

Question Presented

The Circuit Court below held that advances made by Benjamin Gilbert to Gilbor, Inc. constituted capital contributions despite the fact that his advances were made in the form of loans and intended to be loans. In reaching its holding the Court below disregarded the intention of the parties as to the loans and likewise disregarded the ratio of Gilbor, Inc.'s debts to invested capital. The question is this: Under such circumstances is it an error of law to hold

that Gilbert's advances were capital contributions rather than loans?

Statute Involved

The applicable portion of the pertinent statute is set forth in Appendix A, *infra*, p. 19.

Statement

The taxpayers, husband and wife, filed a joint return for the taxable year 1948, claiming bad debt deductions in the amount of $80,404.25 for advances made by them in the years 1946, 1947 and 1948 to Gilbor, Inc. The Tax Court held the advances made by the husband to be contributions to capital, and hence, as to him, did not reach the subsidiary question of whether such advances were deductible only as nonbusiness bad debts within the meaning of Section 23(k)(4) of the applicable Internal Revenue Code of 1939. As to the wife the Tax Court found her advances to be debts but only deductible as nonbusiness bad debts, but this issue and some others decided by the Tax Court in this case are not now in dispute between the parties. Accordingly, the Tax Court affirmed the deficiency assessed by the Commissioner for the year 1948 in the amount of $48,518.65.

Gilbor, Inc. was organized as a New York corporation on June 11, 1946, with an authorized capital stock of $120,000, of which 1,000 shares were preferred stock having a par value of $100, and 20,000 shares were common stock with a par value of $1. Gilbert, the husband, petitioner, and one Borden became the principal stockholders and there was an understanding between them that the financing of Gilbor, Inc. "would be generally on about a 50-50 basis." On June 27, 1946 Borden acquired 4000 shares of common stock in exchange for $40,000, of which $4,000 was credited to capital stock and $36,000 to capital surplus. On July

1, 1946 Gilbert acquired 4000 shares of common stock in exchange for the assets of a business owned by him, which were valued by the directors of Gilbor, Inc. at $40,000, including $2107.85 cash and good will of $35,000. As in the case of Borden, $4000 was credited to capital stock and $36,000 to capital surplus. One share of common stock was issued for $10 cash to one Richards, and $1 was credited to capital stock and $9 to capital surplus. Both Gilbert and Borden became officers and directors and Gilbert, as president, "actively participated in the business" of Gilbor, Inc.

Most of the available cash was promptly expended in the purchase of the stock of other enterprises which Gilbor, Inc. took over, and Borden loaned the corporation $15,000. From time to time, during the years 1946, 1947 and 1948, until the corporation was liquidated at the end of the taxable year 1948, further advances were made by Gilbert and his wife on the one hand, and Borden on the other. The loans by Gilbert, for which demand promissory notes were issued, and the rates of interest payable thereon were as follows:

Oct. 28, 1947	$10,000	Demand	3½% payable semiannually
Dec. 9, 1947	1,000	Demand	3½% payable semiannually
Feb. 20, 1948	6,000	Demand	3½% payable semiannually
May 4, 1948	4,800	Demand	3½% payable semiannually
Aug. 25, 1948	3,000	Demand	3½% payable semiannually
Sept. 1, 1948	1,000	Demand	3½% payable semiannually
Sept. 27, 1948	1,000	Demand	3½%
Oct. 28, 1948	600	Demand	3½%
Dec. 30, 1948	4,000	Demand	3½%
Total	$31,400		

The advances by Mrs. Gilbert were:

Sept. 23, 1946	$ 1,150	Demand	—
Nov. 1, 1946	12,000	Demand (After 1/1/47)	5%
Dec. 12, 1946	10,000	Demand	5% payable semiannually
Jan. 6, 1948	2,500	Demand	3½% payable semiannually
Jan. 8, 1948	5,000	Demand	3½% payable semiannually
Mar. 10, 1948	1,000	Demand	3½% payable semiannually
Apr. 28, 1948	10,000	Demand	3½% payable semiannually
May 26, 1948	4,000	Demand	3½% payable semiannually
June 7, 1948	1,000	Demand	—
July 6, 1948	500	Demand	—
July 12, 1948	500	Demand	—
July 15, 1948	1,000	Demand	3½% payable semiannually
Total	$48,650		

Further advances from time to time were made by Gilbert on open account; but the amount owing Borden at the end was more or less the same as that owing Gilbert and his wife. All these sums were used "for necessary operating expenses." Moreover, shortly after the corporation was organized a loan was negotiated with the Credit Suisse "in order to provide funds with which to conduct the operation of the corporation," and the note covering this loan was guaranteed by both Gilbert and Borden, each of whom put up personally-owned securities as additional security. Other personally-owned securities were loaned at various times by Gilbert and Borden to Gilbor, Inc. and its subsidiaries, to be used as collateral in obtaining other loans from outside sources.

The note payable to Mrs. Gilbert, dated December 12, 1946, for $10,000, contained a provision that it was "transferable immediately into preferred stock," although the privilege was never exercised; and, at the same meeting at which the loan on such terms was authorized, Borden was given an option to purchase the same amount of preferred stock for $10,000, this option to be available only if Mrs. Gilbert exercised her right to convert the note into stock.

During its existence the corporation was actively engaged

in the prosecution of various ventures, with the usual ups and downs, but none of them came up to expectations, and no profit was earned in any year. No interest was ever paid on any of the notes issued to Gilbert or his wife, nor was any interest credited on the books until shortly before the end.

The finding of the Tax Court was: "In view of all of the circumstances established by the voluminous record herein, we have concluded that the advances by Benjamin [Gilbert] were, in reality, contributions of risk capital and did not give rise to bona fide debts on the part of the corporation."

After hearing arguments the Second Circuit Court of Appeals remanded the case to the Tax Court for further proceedings consistent with its opinion. Judge Medina wrote the majority opinion with Judge Waterman writing a concurring opinion. Judge Learned Hand wrote a dissenting opinion which agreed that the case should be remanded but differed with the other two opinions as to the principles which should govern the Tax Court upon reconsideration of the case upon remand.

Upon remand, neither party requested the Tax Court to set the case down again for further trial and the Tax Court, believing that no further findings of evidentiary facts were required, did not set the case for further hearing.

Under the mandate of the Second Circuit, the Tax Court made the following additional findings of ultimate facts:

> "1. At the time of the organization of Gilbor, Inc., and thereafter, petitioners and Borden anticipated and understood that the funds received by Gilbor, Inc., upon the issuance of its capital stock would not be sufficient to finance the conduct of its business.
>
> "2. No outside investor would have made the necessary advances of funds to Gilbor, Inc., without ade-

quate security, which security Gilbor, Inc., was itself unable to provide.

"3. It was at that time understood, and agreed between petitioners and Borden that they would make the advances to Gilbor, Inc., necessary to the conduct of its business (or furnish collateral to it), and that these advances would be made by Borden and by petitioners in proportions which were substantially equivalent to the proportion of the stock of Gilbor, Inc., owned by Borden and of the stock owned by Benjamin Gilbert. The advances were made in such proportion.

"4. The advances made by petitioner Benjamin Gilbert to Gilbor, Inc., were made by him without regard to the normal creditor safeguards.

"5. Petitioner Benjamin Gilbert made no efforts to enforce the obligations evidencing the advances made by him to Gilbor, Inc.

"6. At the time the advances here in question were made to Gilbor, Inc., by Benjamin Gilbert, it was not reasonable to expect that they would be repaid unless the business ventures of Gilbor, Inc., should prove to be successful.

"7. As a matter of substantial economic reality, the advances to Gilbor, Inc., made by Benjamin Gilbert were placed at the risk of the business of Gilbor, Inc., and constituted risk capital."

Because of these specific findings of ultimate facts, the Tax Court concluded that the advances made by petitioner Benjamin Gilbert to Gilbor, Inc., involved in this proceeding did not give rise to debts as that term is used in Section 23(k), Internal Revenue Code of 1939. The Tax Court did not reach that conclusion because of any "secret agreement" between the parties.

The Tax Court did not change its holding with respect to the determination for allowance of nonbusiness bad debts by petitioner Madeline Gilbert.

The taxpayers again appealed to the United States Court of Appeals for the Second Circuit. After hearing arguments that Court promulgated a second opinion affirming the decision of the Tax Court and holding that the advances made by Benjamin Gilbert to Gilbor, Inc. were capital contributions and not loans creating debts within the meaning of Section 23(k) of the Internal Revenue Code of 1939.

Reasons for Granting the Writ

A. The holding of the United States Court of Appeals for the Second Circuit below conflicts in principle with the holdings of other Circuit Courts of Appeal on the identical question.

B. The United States Court of Appeals for the Second Circuit has in this case decided an important question of Federal law which has not been, but should be, settled by this Court.

A. *The holding of the United States Court of Appeals for the Second Circuit conflicts in principle with the holdings of other Circuit Courts of Appeal on the identical question.*

In discussing the the appropriate test to apply here, the Court of Appeals for the Second Circuit explained that, "The determination whether the funds advanced are to be regarded as a capital contribution or 'loan' must be made in the light of all the facts of the particular case. Rarely should one element be determinative." At no point, however, does the opinion below discuss or even advert expressly to the matter of the parties' "intention" which should not be confused with "motive." Strangely,

also, the Tax Court made no determination with respect to "intent" despite the fact that it published two opinions in this case; nowhere does it openly advert to the legal significance of "intent". Indeed, the only reference to "intent" in the entire history of this case appears in footnote 2 of Judge Waterman's concurring opinion on the first appeal in this case. There, he remarked that "only if the Tax Court concludes that the parties truly intended to create debts will the discussion contained in this concurring opinion be revelant."

Judge Waterman regards "intent" as a preliminary test[1] to be satisfied before coming to grips with the factual problem of "substantial economic reality". This is, of course, another instance of the application of the rule of "substance over form". The silence of the other Circuit Judges, The Tax Court and (most significant) the second Opinion of the Circuit Court below with respect to "intent" give tacit approval to this inference. It is clear, therefore, that the parties here intended the advances of Benjamin Gilbert to Gilbor, Inc. to be loans and this is the necessary predicate of the holding below.

In any event, the Court below has couched the test in terms of "substantial economic reality", a factual test. This test would only be applied when determining the true substance of a transaction where the form was such as to indicate a clear intent of the parties to create debts by

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[1] That this is so is demonstrated by Judge Waterman's opinion in *Kraft Foods Co.* v. *Commissioner* (CCA-2, 1956) 232 F. (2d) 118, where he made the following observation equally applicable here: "In the present case, however, the instruments involved are entirely conventional in form and contain no ambiguity on their face. In such a case we think the problem is not one of ascertaining 'intent', since the parties have obviously manifested their intent. It is a problem of whether the intent and acts of these parties should be disregarded in characterizing the transaction for Federal tax purposes."

Against this interpretation Judge Learned Hand's dissent in the first Opinion assumes a special significance.

making loans to corporations. In this frame of reference "intent", as such, plays no direct or significant part. It has already been sufficient (if indicative of loans) to prevent a peremptory and adverse disposition of the issue by satisfying the necessary form. Beyond that function it serves no further purpose in this area. Such is the apparent significance of the holding below despite the statement there that "all the facts" are to be regarded.

Contrast with this holding that of the United States Court of Appeals for the Fifth Circuit [2] in *Rowan et al. v. U. S.* (CCA-5, 1955) 219 F. (2d) 51 in a case involving an identical issue. Judge Tuttle there observed:

> "Recognizing fully that the government is not bound in its tax collecting activities by the terminology used by taxpayers if such terminology is actually used to disguise something quite different [citing *Gregory v. Helvering*], we nevertheless have seen no authority for the proposition that the stockholders of a corporation may not determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit. If they make such a determination and it is clear that such is their intent, the fact that when they close up the venture and take their loss as to such amount as they have actually loaned the corporation, this leaves them in a position to enjoy more favorable deduction privileges than if they had put it all in as capital, this does not entitle the Commissioner of Internal Revenue to rewrite their balance sheet for them and show to be capital what was intended to be a loan.
>
> "But, it is said that whether an advance is a loan or is

[2] See also the case of *Sun Properties, Inc. v. U. S.* (CCA-5, 1955) 220 F. (2d) 171, where the Fifth Circuit reiterates the viewpoint stated here.

> capital *depends on the intent of the parties*, and this intent is to be ascertained from all relevant facts and circumstances." (Emphasis supplied)

It is clear, therefore, that the Fifth Circuit would regard the test of law to be the "intent" of the parties as ascertained from all facts and circumstances. In short, their test is a mixed one with the legal portion actually depending upon and determined "by intent."

This is quite different than the test enunciated by the Court below. The Second Circuit regards the test as entirely factual, described by the Court as the determination of "substantial economic reality". The question of "intent" does not enter into this determination. "Intent" is simply a preliminary question which must be answered affirmatively before a detailed investigation of the facts is warranted.

It is submitted that these two tests are basically irreconcilable and in conflict. The difference in the significance accorded "intent" by the two Courts not only confuses the problem but permits contrary results to be reached on identical facts in the two forums.

Other courts (than the Fifth Circuit) have also recognized the importance of "intent". In *Sam Schnitzer* (1949) 13 T. C. 43, 60, the Tax Court stated:

> "And in deciding whether or not a debtor-creditor relation resulted from advances, the parties' true intent is relevant * * *."

This case was affirmed without opinion by the United States Court of Appeals for the Ninth Circuit. See *Schnitzer et al.* v. *Commissioner* (CCA-9, 1950) 183 F. (2d) 70. In *Dan Chief, et al.* v. *Helvering* (CCA-DC, 1943) 135 F. (2d) 254.

the Court of Appeals for the District of Columbia Circuit stated:

> "The fact that Van Clief made the advances to keep the corporation afloat rather than to liquidate it, has no tendency to show that a voluntary addition to capital rather than a loan was intended."

The latter case was cited with approval in *Maloney et al. v. Spencer* (CCA-9, 1949) 172 F. (2d) 638, where it was stated:

> "The question is what was the taxpayer's intent in agreeing to pay them [corporate notes evidencing loans]."

It may be concluded, therefore, that in addition to the Fifth Circuit, the Ninth Circuit and the District of Columbia Court of Appeals are also in agreement that "intent" is the crucial legal test, not "substantial economic reality".

B. *The Circuit Court of Appeals for the Second Circuit has in this case decided an important question of Federal law which has not been, but should be, settled by this Court.*

The precise question before the Circuit Court below has never been ruled upon by this Court. A somewhat related question[3] came before this Court and was decided in *John*

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[3] Other opinions of this Court in the same category (similar but not the same) would include *Gregory v. Helvering* (1935) 293 U. S. 465 and *Higgins v. Smith* (1940) 308 U. S. 473. While these two cases are frequently cited for general propositions (and were cited below for such purposes), the problem here involved on its own account has achieved a stature and importance at least as great as the somewhat different factual situations involved in those two cases. It would seem reasonable to hope, therefore, that the vitality of the general propositions involved in those cases be more specifically enunciated and clarified in the context of the present problem.

Kelley Co. v. *Commissioner* (1946) 326 U.S. 521. This Court's opinion in that case, however, turned primarily upon the so-called "Dobson's rule" relating to the scope of review of Tax Court opinions, and only incidental *dicta* appears. Nevertheless, the courts have seized these isolated phrases in an attempt to obtain guidance in the very frequently litigated question now before this Court in the petition. Thus the courts hold that "there is no one characteristic • • • which can be said to be decisive in the determination of whether the obligations are risk investments in the corporation or debts." This, of course, suggests that the test to be applied is a factual one.

There is, however, an area in this problem where, as Judge Waterman held in the concurrring opinion on the first appeal below, the question is a mixed one of law and fact. That is to say, in determining what constitutes "debts" as that term is used in Section 23(k) of the Internal Revenue Code, the term itself must be defined and then applied in the peculiar facts of each case. Where, as here, the form of the debt is admittedly perfect and the intent to create debts is conceded, appropriate legal criteria should provide the norms, if substance is to require a different and contrary conclusion. But this problem is plagued by an absence of such exact legal criteria and, consequently, there is unavoidable confusion.

That this is so is indicated in the cases involving this recurrent problem. It has already been shown in A, above, that there is a conflict of the principles applied by the Second Circuit as compared with certain other circuits but this is far from exhausting the confusion.

The divergent views of "intent" as a legal test in the various circuits has another facet which involves the related investigation of adequacy of corporate capital where the nature of stockholders' advances is in question.

This problem is many times approached in the guise of the "thin corporation". It usually involves a comparison of the capital invested in a smaller, closely held corporation with the corporation's indebtedness to its stockholders. This relationship is conventionally expressed as the "debt v. equity" ratio. In addition to the fact that a ratio of this kind furnishes an objective and exact financial norm,[4] there is the fact that the ratio itself may furnish an indication of the parties' intent.

While this Court was careful to refrain from ruling on a situation involving an "obviously excessive debt structure" in *John Kelley Co.* v. *Commissioner, supra,* other courts have regarded such a factor as indicative of intent to make capital contributions. Significantly, in *Talbot Mills* v. *Commissioner* (1946) 326 U. S. 521, the companion case of *John Kelley Co.*, there was involved a ratio of 4 to 1 and this has led to some speculation that ratios, where the debt is less than 4 times as great as capital, will not be challenged by the Commissioner of Internal Revenue. Some substance to this speculation was given when the Commissioner acquiesced in *Ruspyn* v. *Commissioner*, (1952) 18 T. C. 769; Acq. 1952-2 C.B. 3 where the ratio was 3.5 to 1. In any event, cases such as the present one do *not* involve the extreme types of situation which are easier to classify and test; these are the ones in which it is most difficult to draw the line.

Once again there is a curious omission in the opinion

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[4] See Jay O. Kramer, "The Thin Incorporation Problem Today," *The Journal of Accountancy*, December 1958 at p. 48 *et seq.*

[5] It must be stated, however, that the first opinion of the Second Circuit did advert to the ratio in Judge Waterman's concurring opinion where he stated "In a case such as the present, where the ratio of debt to equity never exceeded 2.19 to 1, the 'thin corporation' standard is of no value." As a matter of fact, the ratios during the three years of Gilbor's

of the Court below namely, its silence with respect to the debt-equity ratio. The Tax Court, despite two opinions in this case, never once made a finding of fact with respect to the "ratio" of the corporation involved here.

That the "debt-equity" ratio is an important factor in this type of problem was recognized in the past by the Second Circuit itself. See *Kraft Foods* v. *Commissioner supra*. Aside from any question of error in the Court below in failing to consider the ratio here, there is the problem of how such ratio dovetails with the matter of "intent" in cases where capital is *not* obviously inadequate and *not* merely nominal. The opinion below furnishes no guide lines in this regard.

It is noted that the Circuit Court below held in *Matthiessen* v. *Comm.* (CCA 2-1952) 194 F. (2d) 659 that the issue involved there and here was factual. The same Court, with Judge Waterman speaking, held in the concurring first opinion below that the issue was a mixed one. This is not merely a difference of semantics or just a slip of the tongue. It involves the fundamental question of the need for legal standards as guide lines, the meaning and relevance of "intent" and the significance of debt-equity ratios in the ordinary situation where there is *no* obviously inadequate capital situation.

The history of this case also demonstrates the confusion referred to. The original opinion of the Tax Court contained no reference to intent, ratio or even ultimate findings of fact. The cases relied upon by the Tax Court, *Gooding Amusement Co. Inc.* (1954) 23 T. C. 408 and *Estate of Hex-*

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existence, 1946, 1947 and 1948, were respectively: .57 to 1; 1.35 to 1 and 2.19 to 1.

The "thin corporation" referred to by Judge Waterman was that described by this Court in *John Kelley Co.* v. *Commissioner, supra*, as involving "extreme situations such as nominal stock investments and an obviously excessive debt structure".

bert B. Miller (1955) 24 T. C. 923, were both appealed. The *Miller* case was reversed by the Ninth Circuit in 1956 (239 F. (2d) 729) whereas the *Gooding* case was affirmed (236 F. (2d) 159) by the Sixth Circuit in 1956.[6] Meanwhile, a companion case in the Tax Court, *Kraft Foods Co.* (1954) 21 T. C. 513, was appealed to the Second Circuit and reversed (232 F. (2d) 118).

It may be noted that both *Gooding* and *Miller, supra,* involved small, closely held corporations and, as decided by the Tax Court, seemed to indicate that in such a situation it was virtually impossible for a stockholder to become a creditor of the corporation. This Court denied *certiorari* in the *Gooding* case and this pregnant question is unresolved today.

Returning to the present case, it is observed that upon its first appeal, the Court of Appeals for the Second Circuit, with three judges sitting, wrote three different opinions. Judge Learned Hand dissented from the majority opinions as to the correct *legal* test to be applied.

To further confound the confusion, upon the second appeal in this case, the Second Circuit regarded the issue as factual[7] (despite Judge Waterman's statement in the concurring first opinion that it was a mixed question) and like the Tax Court made no reference to intent or ratio.

The confusion in this area is highlighted by the fact that a recent opinion in a District Court in Illinois[8] cited and applied the test in Judge Learned Hand's dissenting opinion on the first appeal in this case in resolving a com-

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[6] This affirmance did not come to grips with the problem here discussed because it simply held that the Tax Court's findings were not clearly erroneous. There was a strong dissenting opinion on this point.

[7] This is, incidentally, clear evidence that the Circuit Court below has not followed "the law of the case".

[8] *Arlington Park Jockey Club, Inc.* v. *Sauber* (1958) 164 F. Supp. 576; aff'd by Seventh Circuit on February 2, 1959.

parable case, yet upon appeal the Seventh Circuit affirmed, citing the second opinion below.

The ebb and flow of the tides of indecision in this area are obviously of great importance to the small corporate stockholder and developments in this area are under constant surveillance and are reported upon in various journals and periodicals.[9] It may not be amiss to state that there is lack of complete uniformity not only in the circuit courts but in the trial courts as well in their attempts to resolve the difficult question here presented. This is illustrated by the frequency with which this type of issue is litigated.[10] Conceding that the Tax Court might well reach different results in different cases based upon different facts (such as was the situation in *Talbot Mills* v. *Commissioner, supra*, and *John Kelley Co.* v. *Commissioner, supra*) there is the fact, nevertheless, that Tax Court opinions cannot be reconciled on the tests they invoke.[11]

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[9] See, for example, the following representative articles: Bryson, "Stockholder Loans: Thin Capitalization", *Proc. of NYU 8th Annual Institute on Federal Taxation*, p. 732; Kumler, "Capital Structure", *Proc. of The Tax Institute, University of Southern California School of Law*, p. 181; Schlesinger, "Thin Incorporations: Income Tax Advantages and Pitfalls", 61 *Harvard Law Review*, p. 50; Spanbock, Carro and Katz, "Nourishing the Thin Corporation", *Taxes, The Tax Magazine*, Oct. 1956, p. 687; Bittker, "Thin Capitalization: Some Current Questions", *Taxes, The Tax Magazine*, Dec. 1956, p. 830; Note, "Thin Capitalization and Tax Avoidance", 55 *Columbia Law Review*, 1054; Holzmann, "Current Trend in Guaranty Cases" 11 *Tax Law Review*, 29, 45.

[10] To illustrate, the first opinion of the Circuit Court in this case, which was entered on September 26, 1957, has already been cited in six other opinions at the present writing (April, 1959).

[11] For example, compare the various Tax Court opinions in this case with the Tax Court opinion in *Leach Corporation* (1958) 30 T. C. 563. The latter case involved the deductibility of interest on bonds. Despite a debt to equity ratio of 400 to 1, the Tax Court rejected the Commissioner's contention that the bonds in the case actually represented stock. Or compare *G. T. Dorminey* (1956) 26 T. C. 940, Acq., 1957-1 C. B. 4, where in a small, closely-held corporation, the major stockholder's intent was specifically adverted to as was the capitalization of the company.

There would appear to be a clear necessity for guidance in this area to bring about that desirable uniformity of standard and result in the field of taxation. The administration of tax justice would be enhanced and expedited as well. It is respectfully submitted that there is need for guidance by this Court in the important federal tax area encompassed by the question presented.

Conclusion

This petition for certiorari should be granted.

Respectfully submitted,

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APRIL, 1959.

APPENDICES

APPENDIX A

INTERNAL REVENUE CODE OF 1939:

Section 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

. . . . . .

(k) [As amended by Sec. 124(a), Revenue Act of 1942, *supra*, and Sec. 113(a), Revenue Act of 1943, c. 63, 58 Stat. 21] *Bad Debts.*—

(1) General rule.—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

APPENDIX B

THE TAX COURT OF THE UNITED STATES

T. C. Memo. 1956-137

BENJAMIN D. GILBERT AND MADELINE P. GILBERT, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Docket No. 49422

Filed June 12, 1956.

Fred R. Tansill, Esq., and Francis H. Davies, Esq., for the petitioners.

Nathan M. Silverstein, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

The Commissioner determined a deficiency in petitioner's income tax for the calendar year 1948 in the amount of $48,518.65. The issues presented are (1) whether certain advances made by petitioners to a corporation and its subsidiaries in 1946, 1947 and 1948 were loans or capital contributions; (2) if the advances were loans when made, was the loss arising from the worthlessness of the debts in 1948 incurred in petitioners' trade or business; and (3) whether $4,000 advanced to a dissolved corporation on December 30, 1948, if not allowed as a business bad debt deduction, is deductible as a business expense.

FINDINGS OF FACT

A stipulation of certain facts was filed by the parties. We find the facts to be as stipulated and incorporate herein by this reference the stipulation and the exhibits attached thereto.

The petitioners are husband and wife residing in Stamford, Connecticut. They were married in 1937. They filed

their joint Federal income tax return for the calendar year 1948 with the collector of internal revenue for the third district of New York.

Subsequent to graduation from college in 1930, the petitioner, Benjamin Gilbert, engaged in selling securities and acting as investment counsel with a firm owned by his father. At this time he also sold advertisements in programs issued in connection with amateur plays performed by the Players Club of Utica, New York. In 1932 Benjamin left the investment business and went into retail merchandising in Utica, New York, with the Robert Fraser, Inc. department store, where he became assistant to the advertising manager prior to leaving in 1934. During this time he also marketed fruit cakes made by his mother. In 1934 Benjamin was employed by R. H. Macy & Company, a retail department store in New York City, where he was a section manager in various departments. After four or five months' employment with Macy's he resigned to accept employment with Montgomery Ward as a copy writer, but before he actually reported to Montgomery Ward, the job disappeared. He then became connected with an advertising agency in New York City for whom he wrote copy and was an account executive until December 31, 1937. During the period when Benjamin was employed by the advertising agency, he and several other people unsuccessfully attempted to develop and perfect a cold cream.

On December 31, 1937, Benjamin went to work for International Industries at Ann Arbor, Michigan, a concern which manufactured the Argus Camera, Cadet Radio, and microfilm meters. Benjamin was first assigned to the microfilm department, and later was placed in charge of sales and market research on new items which the company might manufacture. Among the new items which Benjamin investigated on behalf of International Industries was a spirit duplicator, a form of ditto machine, that could make up to 400 copies of a piece of material. International Industries accepted the spirit duplicator on Benjamin's recommendation and placed him in charge of its manufacture. In mid-1939 the management of International Industries changed and Benjamin was fired. He then spent some time develop-

ing another type of duplicator which he patented and called a "Sprinter". To manufacture and market the "Sprinter" Benjamin organized a wholly-owned company, Sprinter, Inc., which was financed largely by his wife, the petitioner Madeline. Madeline is a wealthy woman, the niece of John D. Rockefeller, Jr., and the beneficiary of a trust created by him and his sister, Madeline's mother. Shortages of the various materials used in the manufacture of the Sprinter, caused by the mobilization and rearmament programs, forced abandonment of the project at that time. In 1940 Benjamin developed and manufactured through Dash, Inc.,[1] a smaller postcard size mimeograph duplicator which was not so dependent on critical materials. Benjamin organized a sole proprietorship bearing the name Gilbert Sales Company to market this item. However, Dash, Inc. also had to discontinue making the duplicator in 1940 due to shortages in materials.

In 1940 Benjamin formed with one Clarke a partnership which acted as a broker for wooden products which were supplanting plastics, steel and rubber during the war period. The Gilbert and Clarke partnership continued to operate during the war until it terminated in 1945 with the death of Clarke. In 1940 petitioners also were interested in two other enterprises. Madeline invested money in the Adobe Brick Company, and Benjamin became a consultant for that concern. Madeline and Benjamin became stockholders in a concern known as Bolinca, which was engaged in mining gold in South America, which project was ultimately suspended due to the inability to obtain Government permission to transport a dredge from this country to South America.

Benjamin was a partner in a partnership which developed a product known as "Kindle Light" consisting of wood or canvas impregnated with solid oil. One of these products, a small pocket stove for cooking without visible flame, was submitted to the Government for use in the armed forces; however, a competing model was accepted. This partner-

[1] In the transcript of testimony this name appears as "Dase" but the parties in their briefs agree on the spelling of this name as "Dash".

ship also submitted a number of other samples to the Government of products utilizing solid oil such as flares and bombs.

Gilbert acquired a patent for the making of "flock glasses" in 1941. This was a method of spraying rayon, wool, or cotton waste on the outside of a tumbler, thereby giving it a thermal coat so that the glass will not sweat or become moist when filed with an iced beverage. The flocking with these materials was not successful since it washed off too easily, but an improved formula using a latex base was developed which was satisfactory. However, at that time rubber latex could not be obtained in quantity and nothing more was done with the patent.

In 1942 Benjamin and Raphael Atte formed a partnership which later became Gilat, Inc., to engage in making experimental and production tools and dies for the war effort, such as bullet molds, shell molds, aviation spark plugs, guys, and carbide cores used in armor-piercing projectors. Benjamin was active with Gilat, Inc. during the years 1943 to 1945, in which period the concern manufactured these items in sizeable quantities.

Benjamin and Madeline both invested money in oil ventures with a Myrele Walker in 1942. Madeline from time to time invested about one-half million dollars in oil properties in various forms, and received an appreciable income therefrom. In 1944 petitioners bought a family residential property at 8 E. 79th Street, New York City, and sold it at a substantial profit in 1498. Petitioners also leased at some undisclosed time a certain property at 13 Commerce Street, New York City, for a period of fifteen years. This property was a four-story house, of which part was profitably subleased and part occupied by petitioners.

After the death of Clarke terminated the partnership of Gilbert and Clarke in 1945, Benjamin acquired Clarke's interest for $17,500 in cash and carried on its activities as a sole proprietor. The partnership had successfully placed contracts on a commission basis for the manufacture of wooden lockers, benches, stools and threaded bottle caps made of wood. During the war Gilbert and Clarke had been approached and asked to obtain wooden substitutes for

ivory dice and other parts used in a game similar to backgammon and known as "Acey-deucey." Gilbert and Clarke invested some money in the "Acey-deucey" project but the game never caught on and its promotion was dropped. Another interest of Benjamin in 1946 was the Perfect Oven Company (hereinafter referred to as POCO). Petitioners, together with Albert Borden, also purchased stock in the Vacuum Concrete Corporation in 1946.

Gilbor, Inc., a New York Corporation, was formed on June 11, 1946, with an authorized capital stock of $120,000, of which 1,000 shares were preferred stock having a par value of $100, and 20,000 shares were common stock with a par value of $1. Borden acquired 4,000 shares of common stock in Gilbor, Inc. (hereinafter sometimes referred to as Gilbor), on June 27, 1946, in exchange for $40,000 in cash, and became a director and the treasurer of the corporation. Of this $40,000, $4,000 was credited to capital stock and $36,000 to capital surplus. One share of common stock of Gilbor was issued for $10[2] cash to Stewart W. Richards, who also became a director. On July 1, 1946, Benjamin acquired 4,000 shares of common stock of Gilbor in exchange for the assets of Gilbert and Clarke, which were valued by the directors of Gilbor at $40,000, including $2,107.85 cash and good will of $35,000. The activities formerly conducted as Gilbert and Clarke by Benjamin as a sole proprietor continued thereafter as a division of Gilbor. Its principal activity at this time was the production and sale of wooden bottle closures for the cosmetic trade and this activity had been profitable. Benjamin was the president and secretary of Gilbor and actively participated in its management and Borden was treasurer and a director. Madeline was never a shareholder of record, director or officer of Gilbor but she was interested in its problems and informally participated in discussions and decisions of some of its policies. One reason she never became a stockholder, officer or director of Gilbor was because it was generally known that she was a person of great wealth and she did not wish to be subject

[2] In the transcript this amount appears as "$1.00" but the parties in their briefs agree that it properly is the amount of $10.

to any kind of a lawsuit involving the corporation or its management.

When Gilbor was organized, there was $42,117.86 cash available for expenditures. At its first meeting the board of directors authorized and made expenditures of over $38,000, including the purchase of 3,000 shares of Vacuum Concrete Corporation stock for $24,250, the purchase of POCO stock for $12,000, and the payment of organization expenses in the amount of $1,836. At the same meeting the directors deemed it necessary "in order to conduct the business of the corporation" to borrow $15,000 from Borden. A loan of $26,000 was obtained within two months from Credit Suisse "in order to provide funds with which to conduct the operation of the corporation." The note covering this loan was guaranteed by both Benjamin and Borden, each of whom loaned personally-owned securities to Gilbor, which were pledged by it as additional security for the repayment of the Credit Suisse loan. Later, when the loan was renewed, Madeline loaned some securities to Gilbor which it also used as collateral for the Credit Suisse loan.

Gilbor was originally formed for the purpose of developing projects which the stockholders had as well as any other new projects which might come to them. Its corporate powers were extremely broad. The Gilbert and Clarke division was continued so that a steady income would be available for these developments and for establishing subsidiary manufacturing and marketing companies. Shortly after Gilbor was formed, the Gilbert and Clarke division lost its principal supplier of bottle closures or caps and Gilbor decided to acquire a plant of its own. Turned Woods, Inc. was formed as a subsidiary of Gilbor on October 3, 1946, and a man from Maine was hired as its superintendent. However, the subsidiary was not able to manufacture satisfactory bottle caps and eventually this business was lost. Gilbor received 96 per cent (48 shares of common stock) of the outstanding shares of this new subsidiary for $4,800. The day after Turned Woods, Inc. was formed, Gilbor advanced to it $5,000 so it could buy new machinery and improve its plant, and a week later advanced to it $5,000 more to purchase lumber and materials with which to start op-

erations. By January 1947, Gilbor had advanced to it $33,500 and held a note for this amount. At that time Turned Woods had to borrow $7,500 from a Maine bank and in order to accomplish this Gilbor agreed to subordinate its loan to that of the bank. Over $60,000 was advanced to Turned Woods by Gilbor before that subsidiary was sold in November 1948. Gilbor loaned $10,000 to POCO in June 1946, and acquired 96 per cent (48 shares of common stock) of POCO in July 1946 for $2,000 cash and the release of the $10,000 indebtedness. POCO, which was formed to produce and market an oven superior to new commercial ovens then in use, appeared to petitioners to have good prospects in 1946 but was never successful as the manufacturer was unable to produce the ovens at a competitive price. Both Benjamin and Madeline advanced over $3,290 to POCO prior to 1946 and Gilbor advanced almost $13,000 to POCO in 1946 and 1947. Gilbor acquired control of Beaver Wood Products Co., which was in financial difficulties, in January 1948 for $20,830 and changed the name to Beaver Wood Products, Inc. This subsidiary was intended for the production of drawing boards, cutting boards, and other wooden flat work, but failed to produce satisfactorily for Gilbor and its unsatisfactory products seriously affected the good will of Gilbor which had been marketing these products. Gilbor acquired Integrated Wood Products, Inc. for $4,000 in February 1948, and during 1948 Gilbor advanced over $5,000 to this subsidiary. This subsidiary was formed for the purpose of marketing the product of Beaver Wood Products, Inc. because of the loss of good will Gilbor had sustained in handling its unsatisfactory products in the past.

The petitioners and Borden advanced approximately equal amounts to Gilbor in the period 1946 through 1948 for necessary operating expenses. There was the understanding between petitioners and Borden to the effect that the financing of Gilbor "would be generally on about a 50,50 basis" as between petitioners on one hand and Borden on the other. Benjamin advanced funds to Gilbor on or shortly before the dates set forth below for which Gilbor issued de-

mand promissory notes in the amounts and with the terms set forth below:

Date of Note	Amount	Terms	Interest
Oct. 28, 1947	$10,000	Demand	3½% payable semiannually
Dec. 9, 1947	1,000	Demand	3½% payable semiannually
Feb. 20, 1948*	6,000	Demand	3½% payable semiannually
May 4, 1948**	4,800	Demand	3½% payable semiannually
Aug. 25, 1948	3,000	Demand	3½% payable semiannually
Sept. 1, 1948	1,000	Demand	3½% payable semiannually
Sept. 27, 1948	1,000	Demand	3½%
Oct. 28, 1948	600	Demand	3½%
Dec. 30, 1948	4,000	Demand	3½%
Total	$31,400		

* This date was incorrectly stated on the return. (Ex. 1-A-Ex. D(1)) as February 18, 1948.

** This date was also incorrectly reflected on the return where it appeared as April 28, 1947.

Benjamin made addifional advances to Gilbor between September 9, 1946, and December 16, 1948, in the amount of $7,713.88, which were not evidenced by notes but were advanced on open account as needed and were expended for travel, accrued bills, salesmen's salaries, and other miscellaneous expenses, including expenses incurred by Benjamin for which he was not reimbursed. No interest was ever paid or principal ever received back on the monies advanced by Benjamin evidenced by notes or otherwise. He also advanced on open account $1,490 to Turned Woods and $1,750 to Integrated Wood Products between August and October of 1948.

Madeline advanced cash funds to Gilbor on or shortly before the dates set forth below for which Gilbor issued to Madeline demand promissory notes in the amounts and with terms set forth below:

Date of Note	Amount	Terms	Interest
Sept. 23, 1946	$ 1,150	Demand	.....
Nov. 1, 1946	12,000	Demand (After 1/1/47)	5%
Dec. 12, 1946	10,000	Demand	5% payable emiannually
Jan. 6, 1948*	2,500	Demand	3½% payable semiannually
Jan. 8, 1948**	5,000	Demand	3½% payable semiannually
Mar. 10, 1948***	1,000	Demand	3½% payable semiannually
Apr. 28, 1948	10,000	Demand	3½% payable semiannually
May 20, 1948	4,000	Demand	3½% payable semiannually
June 7, 1948	1,000	Demand	.....
July 6, 1948	500	Demand	.....
July 12, 1948	500	Demand	.....
July 15, 1948	1,000	Demand	3½% payable semiannually
Total	$48,650		

* The note comparable to this appearing on the joint return (Ex. 1-A-Ex. D(1)) is erroneously indicated there as being dated January 7, 1948.

** Similar to the foregoing item, this note was erroneously indicated on the return as being dated January 12, 1948.

*** Like the two foregoing items, this note was erroneously shown on the return as being dated March 11, 1948.

The notes payable to Madeline dated September 23, 1946, June 7, 1948, July 6, 1948, and July 12, 1948, contained no interest provision. Printed forms were used for these notes which contained no place for insertion of an interest rate. Madeline never insisted that any of the notes should reflect interest. The rate of interest payable on her notes was fixed by the directors of Gilbor. She did not ask to see any financial data concerning Gilbor before making the advances to it. The note payable to Madeline dated December 12, 1946, was specifically referred to in Gilbor's minutes wherein officers of Gilbor were authorized and empowered "to borrow" $10,000 from Madeline in exchange for a demand promissory note. That note, pursuant to a resolution of Gilbor's board of directors, contained a provision stating that it was "transferable immediately into preferred stock," although that privilege was never exercised. Gilbor's board of directors at the same meeting gave Borilen an option to purchase the same amount of preferred stock ($10,000) for $10,000, but only after Madeline exercised her right to convert the note into stock. No payments of interest or principal were ever made by Gilbor to Madeline on any of her notes. Although all of these notes were in

the form of demand notes, Madeline only made one request in April 1947 for the repayment of a relatively small amount of money. This request was not complied with and she continued to make additional advances under similar circumstances.

Borden also made advances to Gilbor. He advanced funds to Gilbor on or shortly before the dates set forth below, for which Gilbor issued to Borden demand promissory notes, except for three notes with fixed maturity dates of two years, one year and two weeks, respectively, in the amounts and with the terms set forth below:

Date of Advance	Amount	Terms	Interest
July 12, 1946	$15,000.00	2 years	5% semi-annually
Sept. 17, 1946	7,500.00	1 year	5% semi-annually
Apr. 15, 1947	5,000.00	2 weeks	No interest
Apr. 15, 1947	1,400.00	Demand	5%
May 14, 1947	10,600.00	Demand	3½%
May 27, 1947	4,000.00	Demand	3½%
Apr. 19, 1947	5,350.00	Demand	5%
Dec. 2, 1947	250.00	Demand	3½% semi-annually
Dec. 8, 1947	300.00	Demand	3½% semi-annually
Dec. 31, 1947	7,500.00	Demand	3½% semi-annually
Jan. 28, 1948	500.00	Demand	3½%
Feb. 9, 1948	2,000.00	Demand	3½% semi-annually
Feb. 18, 1948	600.00	Demand	3½% semi-annually
Mar. 5, 1948	400.00	Demand	3½% semi-annually
Apr. 28, 1948	7,700.00	Demand	3½% semi-annually
Apr. 29, 1948	3,800.00	Demand	3½% semi-annually
May 21, 1948	500.00	Demand	3½% semi-annually
Aug. 2, 1948	400.00	Demand	3½% semi-annually
Oct. 25, 1948	350.00	Term of note not shown per books	
Oct. 27, 1948	2,500.00	Terms of note not shown per books	
Dec. 30, 1948	2,800.00	Terms of note not shown per books	
May 31, 1948	335.64	Books unclear with respect to this entry.	
	$78,785.64		

No payments of interest or principal were ever made by Gilbor to Borden on account of these notes.

The board of directors of Gilbor determined what the rate of interest on the advances was to be. On April 26, 1947, the directors resolved that thereafter interest on loans made thereafter to Gilbor would be at the rate of 3½ per cent per annum. No interest was ever accrued, paid or reflected on the books of Gilbor with respect to the notes to petitioners or Borden until an audit was made as of July 31, 1948, when the interest on all the advances was accrued and reflected on the books. The petitioner and Borden

never received collateral to secure any of the promissory notes issued them for their advances to Gilbor.

In addition petitioners and Borden loaned personally-owned securities from time to time to Gilbor and its subsidiaries to be used as collateral in obtaining loans from outside sources.

In 1946 and 1947 consolidated returns were filed for Gilbor and its subsidiaries. These returns showed total net losses for the respective years of $15,115.71 and $39,335.94. In 1948 Gilbor filed a separate return which showed a net loss of $137,968.51 and claimed bad debts as follows:

(1) Turned Woods, Inc. for notes receivable and open account items, $67,637.15.

(2) POCO for notes receivable and open accounts, $12,905.65.

(3) Integrated Wood Products for notes receivable and open accounts, $5,481.79.

Gilbor's return for 1948 also reflected worthless securities in these three subsidiaries of a total amount of $17,800.

By December 1948 petitioners had given up any hope that Beaver Wood Products, Inc. would be successful. Gilbor filed a certificate of dissolution on December 16, 1948, pursuant to Article 10 of the New York State Stock Corporation Law because the corporation was then in an insolvent condition, and unable to pay its debts. POCO went into bankruptcy in February 1948. Turned Woods, Inc. and Integrated Wood Products were also insolvent in that year. Benjamin advanced $4,000 to Gilbor on December 30, 1948, to pay rent, salaries and other operating expenses in an effort "chiefly * * * [to] collect the most out of Beaver Wood Products" and also to pay its creditors. Benjamin also advanced in 1948 on open account $1,490 to Turned Woods, Inc. on September 30, 1948, and $1,750 to Integrated Woods, Inc. for the purpose of settling their affairs.

Upon liquidation of Gilbor, Turned Woods, Inc. and Integrated Wood Products, the petitioners received $10,494.63, $40, and $65, respectively. On their joint income tax return

for 1948, petitioners claimed bad debt deductions in the total amount of $80,404.25, consisting of the following:

Gilbor, Inc.	$77,269.25
Turned Woods, Inc.	1,450.00
Integrated Wood Products, Inc.	1,685.00

The Commissioner disallowed these deductions on account of bad debts, but allowed $69,386.67 as long-term losses and $11,017.58 as short-term losses. No deduction of any kind was allowed on account of the $4,000 advanced to Gilbor on December 30, 1948. In their petition, petitioners alleged that the full amount of $80,404.25 was deductible as a business bad debt and, in the alternative, that $76,404.25 was so deductible and the $4,000 advanced to Gilbor in December 1948 was properly deductible as a business expense.

The advances of Benjamin to Gilbor and its subsidiaries were contributions to capital and were not bona fide loans giving rise to a real debtor-creditor relationship.

Madeline's advances to Gilbor gave rise to bona fide debts owed to her by Gilbor, but the loss resulting from their worthlessness was not incurred in her trade or business.

The $4,000 advanced to Gilbor by Benjamin on December 30, 1948, was not deductible as a business expense.

Opinion

Kern, *Judge:* The first question to be determined is whether the advances by petitioners to Gilbor and its subsidiaries were contributions of risk capital or gave rise to bona fide indebtednesses on the part of the corporations. This is essentially a question of fact upon which the petitioners have the burden of proof. *Matthiessen* v. *Commissioner*, 194 F. 2d 659. In that case the Court of Appeals quoted with approval from *Sam Schnitzer*, 13 T.C. 43, aff'd. 183 F. 2d 70, as follows: "Bookkeeping, form and the parties' expression of intent or character, the expectation of repayment, the relation of advances to stockholdings, and the adequacy of the corporate capital previously invested are among circumstances properly to be considered for the

parties' formal designation of the advances are not conclusive * * *."

In the instant case some of the "circumstances" specifically referred to in the above quotation favor the petitioners' contention on this issue and others substantiate the respondent's argument. In view of all of the circumstances established by the voluminous record herein, we have concluded that the advances by Benjamin were, in reality, contributions of risk capital and did not give rise to bona fide debts on the part of the corporation. See *Gooding Amusement Co.*, 23 T.C. 408; *Estate of Herbert B. Miller*, 24 T.C. 923.

The status of Madeline's advances to Gilbor has given us *considerable trouble*. Respondent, in his contention that they are capital contributions, relies upon *Matthiessen v. Commissioner, supra*, affirming 16 T.C. 781. In our opinion the facts of the instant case differ sufficiently from the facts in the Matthiessen case to justify a conclusion that Madeline had an intention, although it was vague and not based upon valid reasoning, that her advances to Gilbor should be loans and this intention was acquiesced in by the corporation, and further, that the facts here justify the ultimate conclusion, which we have reached not without doubt, that Madeline's advances properly had the status of bona fide debts rather than contributions to capital.

However, these debts owing to Madeline were nonbusiness debts the loss from the worthlessness of which was not incurred in her trade or business. The rule of cases such as *Vincent C. Campbell*, 11 T.C. 510, and others relied upon by petitioners as persuasive to the effect that the advances of Madeline to Gilbor gave rise to business bad debts, "is applicable only to the exceptional situations where the taxpayer's activities in promoting, financing, managing and making loans to a number of corporations have been regarded as so extensive as to constitute a business separate and distinct from the business carried on by the corporations themselves." See *Charles G. Berwind*, 20 T.C. 808, 815. It seems obvious to us that this is not one of those exceptional situations.

Madeline is a wealthy woman and appeared to be a de-

voted wife who interests herself in her husband's activities. On several occasions she has given financial assistance to her husband and the business projects in which he has been interested, obviously in an attempt to get her husband established in a successful business. The rendering of this assistance, while perhaps establishing a praiseworthy pattern or conjugal financial cooperation, does not, in our opinion, constitute a trade or business. The few investments shown by the record to have been made on her own account are only of the minimal number and amounts to have been expected on the part of a person of her means.

Petitioners argue on this issue of the non-business character of the debts, if any, that respondent's *present alternative* position to the effect that the debts, if they are debs, are non-business rather than business debts is inconsistent with the statutory notice of deficiency, and that this issue can be raised in this proceeding only by amended answer. It is our view that the respondent's alternative position on this issue is not inconsistent with the deficiency notice and is properly before the Court on the allegations in the petition which are denied in the answer. We also point out that the thorough and able presentation of testimony on this point by petitioners' counsel completely negatives any possibility that there was an element of "surprise" in the consideration of this issue as a part of the case.

Petitioners also contend that the $4,000 advanced by Benjamin to Gilbor on December 30, 1948, even though it was obvious at the time that it would not be repaid, should be deductible as a business expense on the authority of *Gaylord, Inc.*, 41 B.T.A. 1119; *Heller & Son, Inc.*, 12 T.C. 1109; and *Scruggs-Vandervoort-Barney, Inc.*, 7 T.C. 779. However, the record herein does not disclose the existence of facts similar to those in the cited cases which justified there the allowance of deductions. Here there is no evidence that the advances in question were made to protect and promote any business of Benjamin's. They must be considered as a voluntary contribution of capital which was known to be worthless when made and therefore not deductible. *Reading Company v. Commissioner*, 132 F. 2d 306.

Decision will be entered under Rule 50.

APPENDIX C

UNITED STATES COURT OF APPEALS, SECOND CIRCUIT

No. 331

September 26, 1957.

BENJAMIN D. AND MADELINE PRENTICE GILBERT

v.

COMMISSIONER

Before Hand, Medina, and Waterman, Circuit Judges.

Francis E. H. Davies, New York City (Fred R. Tansill and Goodwin, Rosenbaum, Meacham & White, Wash., D. C., of Counsel), for petitioners.

Charles K. Rice, Asst. Attorney General, Hilbert P. Zarky and Fred E. Youngman, Attorneys, Dept. of Justice, Wash., D. C. (Joseph Goetten, Wash., D. C., of Counsel), for respondent.

Medina, Circuit Judge:

This case presents a recurrent problem in the income tax field, namely whether advances by a taxpayer to his corporation will be treated as loans for tax purposes.

The facts are fully stated in the findings and opinion of the Tax Court, 15 T.C.M. 688, but the following abbreviated summary will serve as background to the ensuing discussion. The critical question in the case is: what is the principle to be applied by the finder of the facts in determining whether a given advance of money by a shareholder to a closely held corporation is a loan within the meaning of the Internal Revenue Code? As we cannot tell, from the record before us what was the principle, or what were the standards, applied by the Tax Court, we are remanding the case for further and more explicit findings.

The taxpayers, husband and wife, filed a joint return for the taxable year 1948, claiming bad debt deductions in the amount of $80,404.25 for advances made by them in the

years 1946, 1947 and 1948 to Gilbor, Inc. The Tax Court held the advances made by the husband to be contributions to capital, and hence, as to him, did not reach the subsidiary question of whether such advances were deductible only as nonbusiness bad debts within the meaning of Section 23(k)(4) of the applicable Internal Revenue Code of 1939. As to the wife the Tax Court found her advances to be debts but only deductible as nonbusiness bad debts, but this issue and some others decided by the Tax Court in this case are not now in dispute between the parties. Accordingly the Tax Court affirmed the deficiency assessed by the Commissioner for the year 1948 in the amount of $48,518.65.

Gilbor, Inc. was organized as a New York corporation on June 11, 1946, with an authorized capital stock of $120,000, of which 1,000 shares were preferred stock having a par value of $100, and 20,000 shares were common stock with a par value of $1. Gilbert, the husband, petitioner, and one Borden became the principal stockholders and there was an understanding between them that the financing of Gilbor, Inc. "would be generally on about a 50-50 basis." On June 27, 1946 Borden acquired 4000 shares of common stock in exchange for $40,000, of which $4000 was credited to capital stock and $36,000 to capital surplus. On July 1, 1946 Gilbert acquired 4000 shares of common stock in exchange for the assets of a business owned by him, which were valued by the directors of Gilbor, Inc. at $40,000, including $2107.85 cash and good will of $35,000. As in the case of Borden, $4000 was credited to capital stock and $36,000 to capital surplus. One share of common stock was issued for $10 cash to one Richards, and $1 was credited to capital stock and $9 to capital surplus. Both Gilbert and Borden became officers and directors and Gilbert, as president, "actively participtaed in the business" of Gilbor, Inc.

Most of the available cash was promptly expended in the purchase of the stock of other enterprises which Gilbor, Inc. took over, and Borden loaned the corporation $15,000. From time to time, during the years 1946, 1947 and 1948, until the corporation was liquidated at the end of the tax-

able year 1948, further advances were made by Gilbert and his wife on the one hand, and Borden on the other. The loans by Gilbert, for which demand promissory notes were issued, and the rates of interest payable thereon were as follows:

Oct. 28, 1947	$10,000	Demand	3½%	payable semiannually
Dec. 9, 1947	1,000	Demand	3½%	payable semiannually
Feb. 20, 1948	6,000	Demand	3½%	payable semiannually
May 4, 1948	4,800	Demand	3½%	payable semiannually
Aug. 25, 1948	3,000	Demand	3½%	payable semiannually
Sept. 1, 1948	1,000	Demand	3½%	payable semiannually
Sept. 27, 1948	1,000	Demand	3½%	
Oct. 28, 1948	600	Demand	3½%	
Dec. 30, 1948	4,000	Demand	3½%	
Total	$31,400			

The advances by Mrs. Gilbert were:

Sept. 23, 1946	$1,150	Demand		
Nov. 1, 1946	12,000	Demand (After 1/1/47)	5%	
Dec. 12, 1946	10,000	Demand	5%	payable semiannually
Jan. 6, 1948	2,500	Demand	3½%	payable semiannually
Jan. 8, 1948	5,000	Demand	3½%	payable semiannually
Mar. 10, 1948	1,000	Demand	3½%	payable semiannually
Apr. 28, 1948	10,000	Demand	3½%	payable semiannually
May 26, 1948	4,000	Demand	3½%	payable semiannually
June 7, 1948	1,000	Demand		
July 6, 1948	500	Demand		
July 12, 1948	500	Demand		
July 15, 1948	1,000	Demand	3½%	payable semiannually
Total	$48,650			

Further advances from time to time were made by Gilbert on open account; but the amount owing Borden at the end was more or less the same as that owing Gilbert and his wife. All these sums were used "for necessary operating expenses." Moreover, shortly after the corporation was organized a loan was negotiated with the Credit Suisse "in order to provide funds with which to conduct the operation of the corporation," and the note covering this loan was guaranteed by both Gilbert and Borden, each of whom put up personally-owned securities as additional security. Other personally-owned securities were loaned at various times by Gilbert and Borden to Gilbor, Inc. and its subsidiaries, to be used as collateral in obtaining other loans from outside sources.

The note payable to Mrs. Gilbert, dated December 12, 1946, for $10,000, contained a provision that it was "transferable immediately into preferred stock," although the privilege was never exercised; and, at the same meeting at which the loan on such terms was authorized, Borden was given an option to purchase the same amount of preferred stock for $10,000, this option to be available only if Mrs. Gilbert exercised her right to convert the note into stock.

During its existence the corporation was actively engaged in the prosecution of various ventures, with the usual ups and downs, but none of them came up to expectations, and no profit was earned in any year. No interest was ever paid on any of the notes issued to Gilbert or his wife, nor was any interest credited on the books until shortly before the end.

The finding of the Tax Court was: "In view of all of the circumstances established by the voluminous record herein, we have concluded that the advances by Benjamin [Gilbert] were, in reality, contributions of risk capital and did not give rise to bona fide debts on the part of the corporation."

The problem, which typically arises as the result of an advance by a shareholder to a closely held corporation, has been dealt with in scores of cases. Generally we find an effort by the taxpayer to induce the Commissioner and the courts to make a finding that these transactions are loans. Two major reasons for this are: (1) the Code provides a deduction for "all interest paid or accrued within the taxable year on indebtedness," IRC 1954, Section 163(a), I. R. C. 1939, Section 23(b); and (2) when a business "debt" becomes worthless the lender is entitled to a full deduction not subject to the limitations imposed on capital losses, I. R. C. 1954, Section 166(a), I. R. C. 1939, Section 23(k).[1]

By way of preliminary, it is trite to say that the mere empty form of the transaction does not preclude further

[1] See Note, Thin Capitalization and Tax Avoidance, 55 Colum. L. Rev. 1954; Holzman, Current Trend in Guaranty Cases, 11 Tax L. Rev. 29, 45, which also suggest additional reasons taxpayers may seek to have advances characterized as loans for tax purposes.

inquiry. It is always open to the Commissioner to prove that the transaction is not what it appears, that the parties truly intended to and actually did enter into another and hidden agreement by which their rights are to be governed. It is also clear that, for purposes of the federal tax statute, even though the parties have intended to create a debt, the courts will not recognize it as such as against the taxing power if they have failed to create a binding obligation. Day v. Helvering, 2 Cir., 121 F. 2d 856; Johnson v. Commissioner, 2 Cir., 86 F. 2d 710.

The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof. While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes, Commissioner v. O. P.-P. Holding Corp., 2 Cir., 76 F.2d 11, too great a variation will of course preclude such treatment. Gregg Co. v. Commissioner, 2 Cir., 239 F.2d 498; Jewel Tea Co. v. United States, 2 Cir., 90 F.2d 451.

Assuming then that the true nature of the obligation has been established, and that it is not so unlike a classic debt as to preclude treatment as such, the inquiry is not yet ended, for "the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them." Bazley v. Commissioner, 331 U.S. 737, 741. This principle is generally said to derive from Gregory v. Helvering, 293 U.S. 465, the essential facts of which were as follows. The taxpayer owned all the stock of the United Mortgage Corporation, which had among its assets 1000 shares of the Monitor Securities Corporation. The taxpayer set up the Averill Corporation and three days later United Mortgage transferred to Averill the 1000 shares of Monitar stock, for which all the shares of Averill were issued to the taxpayer. Three days later Averill was dissolved and the taxpayer received the Monitor shares as a liquidating dividend. As a result of these transactions, which were said to be a "reorganization" under Section 112(i) (1) (B) of the Revenue Act of 1928, the taxpayer claimed that a much smaller amount of tax was due than

would have been due if United Mortgage had simply given the taxpayer the Monitor shares as a dividend. The Commissioner disagreed. In upholding the Commissioner the Supreme Court said (293 U.S. at pp. 468-70):

> It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawfull what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States v. Isham, 17 Wall. 496, 506; Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-6; Jones v. Helvering, 63 App. D.C. 204; 71 F.(2) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.
>
> When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [§ 112(g)] of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occured, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plain, not to reorganize a business or any part of a business, but to

transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading, as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt *artifice above reality* and to deprive the statutory provision in question of all serious purpose.

The principle of the Gregory case has been applied again and again by the Supreme Court. In Griffiths v. Helvering, 308 U.S. 355, the Court held that the payment to a wholly owned corporation of a sum due to its owner was properly understood as a payment to the owner for purposes of inclusion in his personal income, stating that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid. * * * Legislative words are not inert, and derive vitality from the obvious purposes at which they are aimed * * *. What Lay gave, Griffiths in reality got, and on that he must be taxed." In Higgins v. Smith, 308 U.S. 473, decided three weeks later, the taxpayer was denied recognition of a loss upon a sale of securities to his wholly owned corporation. "It is clear an actual corporation existed," the Court said, but "There is not enough of substance in such a sale finally to determine a loss." Bazley v. Commissioner, supra, like Gregory, speaks of the necessity for a business purpose in a "reorganization" if it is to be recognized for

tax purposes. The holding is that "A 'reorganization' which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under § 112." The Court held that there had been no "reorganization" within the statutory meaning, even though there undoubtedly had been a reorganization in some sense.

The principle that emerges from these cases is that statutory terms are not to be interpreted independent of their context and underlying policy. "Legislative words are not inert, and derive vitality from the obvious purposes at which they are aimed * * *." Griffiths v. Helvering, supra. Thus, not every plan that reorganizes is a "plan of reorganization" under the Code, not every sale is a transaction that can cause a "loss" for tax purposes, and not every advance cast in the form of a loan gives rise to an "indebtedness" which will justify a tax deduction.

Before discussing what we understand the Congress to have meant by "debt" or "indebtedness", we think it helpful to point out that the taxpayer's motive is not the crucial factor. This is but a corollary of the undoubted proposition, "The incidence of taxation depends upon the substance of a transaction." Commissioner v. Court Holding Co., 324 U.S. 331, 334.

It will be noted that in Gregory the Supreme Court repeatedly stated that the taxpayer's desire to reduce her taxes was irrelevant, that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended," and that tax savings would follow "if a reorganization in reality was effected within the meaning of subdivision (B)." Its holding was that "the transaction upon its face lies outside the plain intent of the statute." Although there had been a reorganization and "No doubt, a new and valid corporation was created," the Court held there was no "reorganization" within the meaning of the Code, because the substance of the transaction did not measure up to what the Congress intended when it used the term. The Court proceeded by "Putting aside * * * the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred * * *." 293 U.S. at 469.

As we said in Johnson v. Commissioner, supra, at p. 712:

> * * * it is too well settled to require discussion that legal transactions cannot be upset merely because the parties have entered into them for the purpose of minimizing or avoiding taxes which might otherwise accrue. Gregory v. Helvering, 293 U.S. 465, 469, 55 S. Ct. 266, 267, 79 L. Ed. 596, 97 A.L.R. 1355; Chisholm v. Commissioner, 79 F.(2) 14, 15, 101, A.L.R. 200 (C.C.A. 2); Sawtell v. Commissioner, 82 F.(2) 221, 222 (C.C.A. 1); Commissioner v. Yeiser, 75 F.(2) 956, 958 (C.C.A. 6). Despite such purpose, the question is always whether the transaction under scrutiny is in reality what it appears to be in form.

And in Loewi v. Ryan, 2 Cir., 229 F.2d 627, we said at p. 629:

> We cannot agree * * * that a taxpayer is not privileged to liquidate his security for whatever purposes he thinks most profitable, among them the reduction of his taxes. It is so abundantly settled in decisions of the Supreme Court [citing cases] that a taxpayer's motive is irrelevant in determining his liability that we need not cite the very numerous decisions of the lower courts. It has at times been said that Gregory v. Helvering * * * is at war with this doctrine * * *. * * * the Act is to be interpreted against its own background, and in deciding how far it adopted all legal transactions that the state law may have covered, it was proper to exclude those that had no other result than to evade taxation.

A dissenting opinion urged that the deduction claimed should be allowed only if the taxpayer chose to liquidate his security at a particular time "because of what he, in good faith, regards as valid business considerations (other than tax reduction) * * *: the taxpayer's subjective reactions, in that respect, are controlling." But we rejected that view, saying, "he is free to choose his time, whatever his purpose." We held the controlling factor to be result, not motive.

In Kraft Foods Co. v. Commissioner, 2 Cir., 232 F.2d 118, we reaffirmed our holding in the Loewi case, saying at pp. 127-28:

> The Commissioner contends that the debenture issue should be disregarded for tax purposes because it served no business purpose other than the minimization of taxes. Although the taxpayer attempts to find a business purpose in the replacement of an artificial financial structure with a more realistic one, it concedes that tax considerations were the primary motivation of the debenture issue. Assuming, then, that the purpose of the transaction was to minimize taxes, should the transaction be disregarded because of its tax motivation?
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> The Commissioner argues that transactions, though formally perfect and in compliance with a provision of the tax statute, must be disregarded if they have no purpose germane to the conduct of the business other than tax minimization. He relies on Gregory v. Helvering, 1935, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596; Minnesota Tea Co. v. Helvering, 1938, 302 U.S. 609, 58 S. Ct. 393, 82 L. Ed. 474; Griffiths v. Helvering, 1939, 308 U.S. 355, 60 S. Ct. 277, 84 L. Ed. 319; Higgins v. Smith, 1941, 308 U.S. 473, 60 S. Ct. 355, 84 L. Ed. 406; Commissioner of Internal Revenue v. Court Holding Co., 1945, 324 U.S. 331, 65 S. Ct. 707, 89 L. Ed. 981; Bazley v. Commissioner, 1947, 331 U.S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782; Commissioner of Internal Revenue v. Culbertson, 1949, 337 U.S. 733, 69 S. Ct. 1210, 93 L. Ed. 1659. We do not think that these cases hold that tax minimization is an improper objective of corporate management; they hold that transactions, even though real, may be disregarded if they are a sham or masquerade or if they take place between taxable entities which have no real existence. The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact.

In many cases in which the Gregory principle is called into play the question is whether a tax-significant trans-

action has occurred. But this is not to say that Gregory has application only where the question is whether a transaction is to be completely ignored for tax purposes. The principle is fully as applicable where there is no doubt that a very real transaction has taken place and the question is whether the characterization urged by the taxpayer accords with substantial economic reality. In either case the taxpayer must show that his treatment of the transaction does not conflict with the meaning the Congress had in mind when it formulated the section sub judice.

This principle must be observed in determining whether advances are properly treated as loans under the "interest on indebtedness" and "bad belt" sections of the Code. As we said in Kraft Foods Co. v. Commissioner, supra, at p. 123, "It is now a commonplace that words have many meanings, each dependent upon their context. Thus, 'indebtedness' as used in a federal taxation statute may not carry the same meaning as the same word used in the context of corporate finance." Numerous cases have denied taxpayers deductions on the ground that obligations which constituted valid indebtedness for other purposes were not such within the meaning of the Internal Revenue Code. A large collection of such cases and incisive analyses may be found in the Columbia Law Review note cited in footnote 1 and in 4 Mertens, Law of Federal Income Taxation §§ 26.12-26.10c.

There can be little doubt that such holdings are correct where the advances were made under such circumstances as to negative any reasonable expectation of repayment. Thus, in Hoyt v. Commissioned, 2 Cir., 145 F.2d 634, we held that "notes taken on account of advances by a taxpayer who believes at the time that the notes are worthless and uncollectible cannot be deducted as bad debts because they are in the nature of gifts," and in American Cigar Co. v. Commissioner, 2 Cir., 66 F.2d 425, we held that "advances, made in the belief they would not be repaid, are in the nature of gifts, and are not deductible as bad debts."

Not all cases are so clear, however, and in determining whether advances to closely held corporations may properly be treated as loans for tax purposes, the courts have stressed one or more of a number of factors, including the debt-

equity ratio, presence of an agreement to maintain proportionality between the advances in question and acknowledged risk capital, presence of tax avoidance motives, the use to which the funds were put, whether outside investors would make such advances, and lack of reasonable expectation of repayment. These are proper subjects of consideration, for the Congress evidently meant the significant factor to be whether the funds were advanced with reasonable expectations or repayment regardless of the success of the venture or were placed at the risk of the business, and, as we shall show, each of the enumerated items does or may bear on the degree of the risk involved.

From the point of view of the corporation, the Code allows a deduction for "interest paid * * * on indebtedness," yet it allows no deduction for dividends paid. Thus, where a corporation pays for the use of money which it will return, it is in effect allowed a deduction for a business expense, just as it is allowed a deduction for the expense of renting a building. Where, however, a corporation pays dividends, it is not incurring a business expense; it is distributing profits. While interest and profits are not always distinguishable, they are distinct concepts, and the distinction, however imperfect it may be in a particular case, lies in the degree of risk involved. Thus, it would do violence to the congressional policy to permit an "interest" deduction where the "loan" is so risky that it can properly be regarded only as venture capital.

Similarly, the Congress decreed different treatment for the loss of funds advanced with reasonable expectations of repayment, whether to earn interest or for some other reason, than it did for the loss of funds risked upon the success of a business venture. Here again it would do violence to the congressional policy to allow a bad debt deduction in the case of a loss which is as a matter of substantial economic reality a loss of risk capital.

The relationship of "nominal stock investments" or "an obviously excessive debt structure," to use the phrases employed by the Supreme Court in John Kelley Co. v. Commissioner, 326 U.S. 521, 526, to the degree of risk involved is clear. Any "loan" to the corporation in such

circumstances would necessarily be venture capital in reality, for any business loss by the corporation would be reflected in an inability to repay the "loan."

An agreement to keep "loans" proportioned to acknowledged risk capital is indicative that the funds "loaned" were understood to have been placed at the risk of the business. There is no apparent reason for such an agreement where repayment seems faifly certain. Such an agreement is readily understood, however, where there is real danger that the money might be lost, for by means of such an agreement each stockholder risking additional capital in the form of a "loan" can be assured that his percentage of the equity and control will remain in correspondence with his shares of the risk. In other words, a reluctance to "lend" money to the corporation unless his fellow shareholders "lend" proportionate amounts belies a feeling of confidence that the funds will be returned regardless of the success of the venture. And the shareholder's understanding of the degree of risk involved is of course relevant in determining what is in fact the degree of risk involved.

Where the courts have spoken of tax avoidance motives, they have as a rule had reference to their conclusions rather than to the evidence. The statement that the taxpayer was seeking to avoid taxes has been used as the equivalent of the statement that the taxpayer has tried to base a deduction on an advance which was in fact too risky to qualify as a loan for tax purposes. As we have shown, the motives and expectations of the taxpayer are relevant only insofar as they contribute to an understanding of the external facts of the situation.

The relationship to the degree of risk of the use of the funds advanced, whether outsiders would be willing to make such advances, and the reasonableness of the expectations of repayment are too plain to require discussion.

Turning now to the case before us, we are unable fully to understand the basis for the Tax Court's holding that "the advances made by Benjamin [Gilbert] were, in reality, contributions of risk capital and did not give rise to bona fide debts on the part of the corporation." Moreover, it is

difficult to know whether the Tax Court meant to hold that because of some secret agreement the parties did not establish a debtor-creditor relationship in any sense, or that although such relationship was established it did not give rise to debts as that term is used in the Internal Revenue Code. It is the duty of the Tax Court to distinguish with clarity what it finds as fact, and what it holds as conclusions of law. Dobson v. Commissioner, 320 U.S. 489 (1943).

Even if the decision of the Tax Court is construed as resting only on the latter ground, i.e., that the advances did not give rise to debts as that term is used in Section 23(k), we are reluctant to affirm, or to reverse its decision without remanding back for further findings. The opinion of the Tax Court only states a conclusion without assigning the reasons therefor. This makes it impossible for us to determine whether appropriate standards have been employed in reaching that conclusion.

Furthermore, in considering the advances by the wife to the corporation the Tax Court apparently treated as determinative its finding that "Madeline had an intention, although it was vague and not based upon valid reasoning, that her advances to Gilbor should be loans and this intention was acquiesced in by the corporation * * *." 15 T.C.M. at 694. Insofar as this indicates either that the Tax Court adopted some sort of subjective test or that all inquiry ends upon a finding that the obligation actually created will be treated as debt for non-tax purposes, we think that court erred.

Accordingly, the cause is remanded for proceedings consistent with this opinion.

WATERMAN, Circuit Judge (concurring):

I concur in remanding this cause to the Tax Court for further proceedings. The opinion of the Tax Court does not state the ground upon which its decision rests. Therefore, affirmance or outright reversal by us would not be a review of the Tax Court's decision but an initial determination by us of the correctness of the deficiency assessed by the Commissioner.

The differences within our Court relate to the stating of the principles that we believe should govern the Tax

Court when it reconsiders this case upon remand.[2] I am in accord with the approach expressed by Judge Medina.[3]

The petitioners and the Commissioner have argued this appeal upon the theory that the decision of the Tax Court was a decision of fact and that it may not be disturbed unless clearly erroneous. I cannot agree. The issue before the Tax Court and this court is whether the advances made by Gilbert gave rise to "debts" as that term is used in Section 23(k) of the Internal Revenue Code. Such an issue is not merely one of fact. It is an issue—often called a "mixed question of law and fact"—which calls for the application of a statutory term to a particular set of facts. Prior to 1948, the courts were required to affirm Tax Court decisions made in cases that involved such mixed questions if the decision had "a warrant in the record and a reasonable basis in the law." Dobson v. Commissioner, 320 U.S. 489, 501 (1943). But in that year, Congress amended 26 U.S.C. 1141(a)[4] and this amendment, becoming law sub-

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[2] There is, of course no disagreement among the members of the court if the decision of the Tax Court, based upon substantial evidence, is that the notes in issue were a mere pretense and "that the parties truly intended to and actually did enter into another and hidden agreement by which their rights were to be governed." Only if the Tax Court concludes that the parties truly intended to create debts will the discussion contained in this concurring opinion be relevant.

[3] I do not understand Judge Medina's opinion to hold that the motive of a taxpayer is never a proper subject of inquiry. Cases may arise, indeed, this may be one, in which the Commissioner may contend that the way the taxpayer reports a transaction upon his income tax return must be disregarded because it does not evidence the entire true transaction and is a mere pretense. In such a case, the desire of the taxpayer to avoid his taxes is a relevant subject for inquiry because it provides a motive for the sham which the Commissioner seeks to prove.

[4] This amendment inserted the italicized words into the statute:

1141 (a). The United States Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, *in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury;* and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code.

sequent to the decision in Dobson v. Commissioner, requires, I believe, that we examine in detail the issues presented here.

If characterization of the advances made by Mr. Gilbert depended solely upon the terms of the instruments under which the parties' rights were governed, it is clear that the decision of the Tax Court would have to be reversed. Each note received by Gilbert contained an unconditional promise to pay 3½% interest semi-annually and to pay the principal upon demand. The notes were transferable, and did not by their terms confer the right to participate in the management of the corporation.[5] Moreover, the notes were not subordinated to the claims of other creditors. Unlike the situation presented in Gregg v. Commissioner, 239 F.2d 498 (2 Cir., 1956), where so-called "hybrid" securities were involved, these instruments are on their faces ordinary unsecured interest-bearing promissory notes payable upon demand.

But numerous cases have indicated that even though the form of the instrument evidencing an advance of funds is appropriate to the creation thereby of a debt, the circumstances surrounding the creation of the obligation may be such as to indicate that characterization of the advance as a loan would be improper within the meaning of the federal tax statute. Thus, in Reed v. Commissioner, 242 F.2d 334 (2 Cir. 1957), where the instruments were promissory notes similar to the obligations in the present case, this court after an appraisal of the surrounding circumstances, sustained the Tax Court's determination that the advances there in question were contributions to capital and not loans. Cf. Gregg Co. v. Commissioner, supra.

Although the facts of Dittmar v. Commissioner, 1955, 23 T.C. 789, are not identical with those in the present case, that decision is not without application here. There, the taxpayer, a stockholder, had made continuous advances to the corporation in response to needs for both capital assets and working capital without regard to the normal creditor

[5] This factor is, of course, of limited significance in a closely held corporation, especially where, as here, the notes are issued in proportion to shareholdings.

safeguards. Under these circumstances, it was held that the advances were not loans to the corporation as the taxpayer contended but were contributions to corporate capital. It is true that in that case, unlike the present case, no formal instruments evidencing indebtedness were executed, but the similarities in the two cases are most impressive. In each the alleged loans were unsecured even though the interest on prior loans was in default and the corporation had a continuous history of losses. In each no attempt was ever made to enforce the obligations.[6] Since the distinction between loans and contributions to capital depends in part upon the type of risk assumed by an investor, the fact that the advances were made under circumstances more closely approximating those associated with the investment of equity capital is relevant to a determination of the character of the advances for purposes of federal income taxation.

Another circumstance tending to support the conclusion of the Tax Court is the agreement between petitioner and Borden that the financing of Gilbor, Inc., was to be shared equally between them. While this factor is not conclusive, it is one which "subjects the transaction to close scrutiny." Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718, 721 (9 Cir. 1949); 1432 Broadway Corp. v. Commissioner, 1945, 4 T.C. 1158, aff'd per curiam, 2 Cir. 1947, 160 F.2d 885. The agreement has particular significance in this case because of other evidence that the parties intended that distributions made by the corporation should at all times be equal to their proprietary interests. In December 1946, the board of directors authorized the officers of Gilbor to borrow $10,000 from Mrs. Gilbert in exchange for a demand promissory note. That note, pursuant to the resolution of the board, contained a provision that it was "transferable immediately into preferred stock." At the same meeting the board of directors gave Borden an option to purchase $10,000 of preferred stock, exercisable by him only upon the condition that Mrs. Gilbert exercise her conversion

[6] These facts would also tend to support an inference that at the time the advances were made the parties did not truly intend that they should give rise to enforceable debts.

rights. The clear purpose of granting this option to Borden was to protect his right to share equally with the Gilberts in the anticipated distributions of the corporation.

The Commissioner also relies upon the fact that the cash available for expenditures was from the beginning insufficient to finance the scope of activities which the parties apparently planned. The pertinence of this argument is not, however, clear. We have decided several cases in which the inadequacy of equity capital contributed to characterization of advances as contributions to capital rather than as loans. E.g., 241 Corporation v. Commissioner, 242 F.2d 759 (2 Cir., 1957); 1432 Corp. v. Commissioner, supra. But, as indicated by the Supreme Court in John Kelley Co. v. Commissioner, 1946, 326 U.S. 521, this test has value only in "extreme situations such as nominal stock investments and an obviously excessive debt structure." In a case such as the present, where the ratio of debt to equity never exceeded 2.19 to 1, the "thin corporation" standard is of no value. It is not clear, however, whether this is the thrust of the argument, or whether the Commissioner contends that since the parties from the start knew there would be a need for larger amounts of capital, all later advances must be considered as having been invested as equity rather than having been loaned. In either case, it would appear that the argument must fail. Once it is established that the parties' equity investment is more than nominal, the means by which the corporation's activities are financed is a matter to be handled in whatever way seems most advantageous to it. Wilshire & Western Sandwiches, Inc. v. Commissioner, supra.

It appears to me that the only factors which tend to support the conclusion of the Tax Court are that the advances were made in proportion to the equity investments of the parties and that they were continuously made without regard to normal creditor safeguards under the circumstances.[7] The need for safeguards is attested to by the fact that when the parties obtained outside loans these loans

[7] The record discloses that this factor may have been given little weight by the Tax Court, for it characterized the advances made by Mrs. Gilbert as loans even though she never sought or obtained such safeguards.

were secured not only by the property of the corporation, but also by the personal guarantees of Gilbert and Borden. Whether these factors are sufficient to preclude characterization of the advances as loans for income tax purposes is a question which, at least in the first instance, must be answered by the Tax Court.

HAND, Circuit Judge (dissenting):

The Tax Court found that Gilbert's advances to Gilbor, Inc., did not create "bona fide debts," and to that I cannot agree, for I can find no evidence that would support that conclusion, if by "bona fide debts" one means debts that are valid as between the petitioners and the corporation. Whatever may have been the earlier doctrine it is, I think, now settled that a debt to the holder, or holders, of all the shares of a corporation will in case of insolvency be on a parity with debts to outsiders. It is true that in Flynn v. Loewer Realty Co., 167 F.2d 318, 320 (C. A. 2) we said that a sole shareholder who lends money to the corporation, is at an advantage over outside creditors in that he controls the conduct of the enterprise, and is actuated by the hope of more than the return of his principal and interest; but that alone is no reason for imposing upon him a fiduciary relation vis-a-vis other creditors. In any event, whatever may have been the effect of the earlier decisions, in Comstock v. Group of Investors, 335 U.S. 211, 229, the Supreme Court declared that some abuse of the shareholder's control must appear before his debt loses its parity with other debts: "In the case before us there was domination of the subsidiary, a relationship between corporations which the law has not seen fit to proscribe. * * * It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong." Our latest decisions have been in accord with this doctrine,[8] and I can see no distinction between a

[8] Schwartz v. Mills, 192 F.2d 727; Gannett Co. v. Larry, 221 F.2d 269; Kraft Foods Company v. Commissioner, 232 F.2d 118, 126.

case of two corporations, one holding all the other's shares, and a corporation and two individuals, who between them hold all its shares and act in common. Hence it follows that, if Gilbert and Borden in fact meant to make their advances debts of the corporation there was nothing to defeat their purpose.

However, it is also settled that although the rights of a taxpayer may be absolute as between himself and his corporation, the law will at times refuse to regard those rights in assessing his income tax. That doctrine stems from Gregory v. Helvering, 293 U. S. 465; at least that is the source usually ascribed to it. It is a corollary of the universally accepted canon of interpretation that the literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their "interpretation" demands the projection of their expressed purpose, upon occasions, not present in the minds of those who enacted them. The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. Gregory v. Helvering, supra; Griffiths v. Commissioner, 308 U. S. 355; Higgins v. Smith, 308 U. S. 478; Bazley v. Commissioner, 331 U. S. 737, 741. When a taxpayer supposes that the transaction, in addition to its effect on his tax, will promote his beneficial interests in the venture, he will of course secure the desired reduction, for it would be absurd to hold that he must deny himself an economic advantage unless he pay the tax based upon the facts that have ceased to exist. Moreover, he will also be relieved, if he supposes that the transaction will, or may, cause him a loss, although in that event it is true that his only motive will be to avoid the tax. For instance, if a very rich man sells shares of stock and invests the proceeds in municipal bonds, he will not be taxed on the dividends

of the shares, although his only motive was to avoid the tax upon his dividends. It might have been possible in such situations, when the only motive was to reduce taxes, to assess a tax, measured by the difference between the tax still due, and that that would have been due but for the transaction. However, there is not the slightest intimation of such a doctrine in any of the decisions; it covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally.

I am not sure that this differs from what my brothers mean; but I do not agree with the form of the test that, as I understand it, they wish the Tax Court to adopt; and, indeed, I am not clear as to what it is. To say that it is whether the transaction has "substantial economic reality," or "is in reality what it appears to be in form," or is a "sham" or a "masquerade," or "depends upon the substance of the transaction": all of these appear to me to leave the test undefined, because they do not state the facts that are to be determinative.

I would therefore substitute this which seems to me to avoid that defect and at the same time state the doctrine adequately:

> "When the petitioners decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?"

The burden will be on them to prove that they did so suppose.

Remanded.

APPENDIX D

BENJAMIN D. GILBERT AND MADELINE PRENTICE GILBERT

v.

COMMISSIONER

Docket No. 49422. T. C. Memo. 1958-8

Filed January 23, 1958.

Fred R. Tansill, Esq., and Francis E. H. Davies, Esq., New York City, New York, for the petitioners. Nathan M. Silverstein, Esq., for the respondent.

Supplemental Memorandum Findings of Fact and Opinion

KERN, Judge: This proceeding is now before us pursuant to a judgment of the United States Court of Appeals for the Second Circuit filed on September 26, 1957, wherein it is ordered that the case be "remanded in accordance with the opinion of this court." That opinion, filed the same day, is reported at 248 Fed. (2d) 399.

We have studied carefully the opinion of Judge Medina, the concurring opinion of Judge Waterman, and the dissenting opinion of Judge Hand.

Although Judge Medina's opinion recites that "The facts are fully stated in the findings and opinion of the Tax Court," he says that "As we cannot tell from the record before us what was the principle, or what were the standards, applied by the Tax Court, we are remanding the case for further and more explicit findings," and later in his opinion he says:

> "The opinion of the Tax Court only states a conclusion without assigning the reasons therefor. This makes it impossible for us to determine whether appropriate standards have been employed in reaching that conclusion."

His opinion ends as follows: "Accordingly, the cause is remanded for proceedings consistent with this opinion."

Judge Waterman, in his concurring opinion, says:

> "I concur in remanding this cause to the Tax Court for further proceedings. The opinion of the Tax Court does not state the ground upon which its decision rests. Therefore, affirmance or outright reversal by us would not be a review of the Tax Court's decision but an initial determination by us of the correctness of the deficiency assessed by the Commissioner."

We are in some doubt as to what "proceedings consistent with this opinion" or what "further proceedings" are called for under the judgment of the Court of Appeals. The facts were fully developed at the trial of this case. What we said in our opinion as to one issue is true of all the issues herein: There was a "thorough and able presentation of testimony * * * by petitioners' counsel * * *." And Judge Medina, in his opinion, says that in our findings "The facts are fully stated * * *." Therefore, we cannot see that any useful purpose would be served by setting this case down for further trial. Neither party hereto has requested such action on our part. Nor can we see that any further findings of evidentiary facts are required by us.

As we construe the judgment and opinions of the Court of Appeals, it is proper for us, in our attempt to comply with that judgment, to make certain specific findings of ultimate facts, as destinguished from findings of evidentiary facts. Accordingly, and based upon the findings of evidentiary facts heretofore made by us and the entire record herein, we make the following additional findings:

1. At the time of the organization of Gilbor, Inc., and thereafter petitioners and Borden anticipated and understood that the funds received by Gilbor, Inc., upon the issuance of its capital stock would not be sufficient to finance the conduct of its business.

2. No outside investor would have made the necessary advances of funds to Gilbor, Inc., without adequate security, which security Gilbor, Inc., was itself unable to provide.

3. It was at that time understood and agreed between petitioners and Borden that they would make the advances

to Gilbor, Inc., necessary to the conduct of its business (or furnish collateral to it), and that these advances would be made by Borden and by petitioners in proportions which were substantially equivalent to the proportion of the stock of Gilbor, Inc., owned by Borden and of the stock owned by Benjamin Gilbert. The advances were made in such proportion.

4. The advances made by petitioner Benjamin Gilbert to Gilbor, Inc., were made by him without regard to the normal creditor safeguards.

5. Petitioner Benjamin Gilbert made no efforts to enforce the obligations evidencing the advances made by him to Gilbor, Inc.

6. At the time the advances here in question were made to Gilbor, Inc., by Benjamin Gilbert, it was not reasonable to expect that they would be repaid unless the business ventures of Gilbor, Inc., should prove to be successful.

7. As a matter of substantial economic reality, the advances to Gilbor, Inc., made by Benjamin Gilbert were placed at the risk of the business of Gilbor, Inc., and constituted risk capital.

Because of these specific findings of ultimate facts, we conclude that the advances made by petitioner Benjamin Gilbert to Gilbor, Inc., involved in this proceeding, did not give rise to debts as that term is used in section 23(k), Internal Revenue Code of 1939.

We do not reach that conclusion because of any "secret agreement" between the parties.

A close reading of the opinion of the Court of Appeals, which accompanied its judgment herein, suggests that we may have erred, in that Court's opinion, in allowing deductions on account of nonbusiness bad debts by petitioner Madeline Gilbert. As is indicated by our prior opinion herein, we had grave doubts as to this issue. However, the judgment of the Court of Appeals does not appear to call for any action on our part with regard to that issue, and we consider it advisable for us to limit our present action herein to an attempt on our part to comply with the judgment of that Court, since neither party has requested us to

reconsider our decision insofar as it relates to petitioner Madeline Gilbert.

We have no doubt as to the correctness of our conclusion with regard to the advances made by petitioner Benjamin Gilbert. We have the temerity to hope that we have adequately assigned the reasons for that conclusion, and have thus complied with the judgment of the Court of Appeals.

Decision will again be entered herein that there is a deficiency in petitioner's income tax for the year ended December 31, 1948, in the amount of $48,518.65.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 102—October Term, 1958.

(Argued November 12, 1958 Decided January 14, 1959.)

Docket No. 25246

BENJAMIN D. and MADELINE PRENTICE GILBERT,
Petitioners on Review,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent on Review*

Before: HINCKS, LUMBARD and MOORE, *Circuit Judges.*

Taxpayers Benjamin D. and Madeline P. Gilbert petition for a review of the decision of the Tax Court, entered January 23, 1958, Kern, *Judge*, ordering and deciding that there was a deficiency in petitioners' tax return for the calendar year 1948 in the amount of $48,518.65, which decision was based on a finding that advances made by Benjamin D. Gilbert to a corporation of which he was a stockholder were contributions of capital and not loans on which a deduction for bad debts could be taken under section 23(k) of the Internal Revenue Code of 1939.

Affirmed.

FRED R. TANSILL, Esq., Washington, D. C. (Francis E. H. Davies, Esq., Goodwin, Rosenbaum, Meacham & White, Washington, D. C., on the brief), *for Petitioners on Review.*

MELVIN L. LEBOW, Esq., Attorney, Department of Justice, Washington, D. C. (Charles K. Rice, Assistant Attorney General, Lee A Jackson, Harry Baum, Attorneys, Department of Justice, Washington, D. C., on the brief), *for Respondent on Review.*

MOORE, *Circuit Judge:*

This is a petition for review of a decision of the Tax Court, entered January 23, 1958, which sustained the Commissioner's determination of deficiency in the income tax of Benjamin D. and Madeline P. Gilbert for the calendar year 1948 in the amount of $48,518.65. The Tax Court's decision was based on a finding that advances made by Benjamin to a corporation of which he was a stockholder were capital contributions and not loans for which a deduction could be taken under section 23(k) of the Internal Revenue Code of 1939. The matter is before this court for the second time. On the first appeal the court remanded the cause for proceedings consistent with its opinion (248 F. 2d 399). The court desired to know "what was the principle, or what were the standards, applied by the Tax Court" and requested "further and more explicit findings." The Tax Court "studied carefully" the three opinions of Judges Medina, Waterman and Hand and was "in some doubt as to what 'proceedings consistent with this opinion' or what 'further proceedings' [were] called for under the judgment of the Court of Appeals." Since "[T]he facts were fully developed at the trial of this case," and since it could not find that "any useful purpose would be served by setting this case down for further trial" the Tax Court on the same record attempted to comply with the judgment and opinion of the Court of Appeals by making "certain specific findings of ultimate facts, as distinguished from findings of evidentiary facts." Neither party requested a hearing for the introduction of additional evidence. The Tax Court, therefore, sufficiently complied with this court's direction by making additional findings which disclosed the "standards" upon which its decision rested.[1]

In summary, the seven new findings as they apply to petitioner Benjamin D. Gilbert are: (1) Benjamin anticipated and understood that the funds received by Gilbor, Inc., upon the issuance of its capital stock, would not be

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[1] The pertinent facts are fully stated in the original findings and opinion of the Tax Court (15 T. C. M. 688) and in this court's first opinion (248 F. 2d 399).

sufficient to finance the conduct of its business; (2) no outside investor would have made similar advances without security; (3) the advances were made substantially in proportion to the stock ownership of the stockholders; (4) the advances were made without regard to the normal creditor safeguards; (5) no effort was made to enforce the obligations; (6) Benjamin had no reason to expect repayment unless the business were successful; and (7) that as a matter of "substantial economic reality" the advances by Benjamin were placed at the risk of the business of Gilbor, Inc., and constituted risk capital.

These findings are relevant to the resolution of the problem posed by this court in its previous opinion (248 F. 2d 399), namely "whether advances by a taxpayer to his corporation will be treated as loans for tax purposes."

On this appeal, petitioner Benjamin claims, first, that the Tax Court failed to follow this court's directions in that it did not advert to certain indicia mentioned in the opinion of Judge Medina, such as debt-equity ratio, tax avoidance motives and the use to which the funds were put; and, second, that the findings do not justify its holding that Benjamin's advances to Gilbor, Inc. were for tax purposes capital contributions and not loans.

The only question, however, now before this court is whether upon the law and the facts in the record the Tax Court was justified in concluding that the advances by Benjamin were not deductible as bad debts in his 1948 income tax return under section 23(k) of the Internal Revenue Code of 1939. Conversely, the question is not whether all possible problems discussed in the previous opinion have been specifically dealt with by the Tax Court but only whether the findings as actually made are supported by the evidence and lead to the conclusion reached as a matter of law.

Certain of the principles here applicable have been frequently stated by the courts. Whether advances to a corporation are contributions to capital or loans "is essentially a question of fact upon which the taxpayer has the burden of establishing his right to such deduction" (*Matthiessen* v. *Commissioner of Internal Revenue*, 2 Cir., 1952, 194 F. 2d 659, 661). The form of the transaction is not

controlling, but rather the substance. *Gregory* v. *Helvering*, 293 U. S. 465; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *1432 Broadway Corporation* v. *Commissioner*, 1945, 4 T. C. 1158, affirmed *per curiam*, 2 Cir., 1947, 160 F. 2d 885. Where the loss sought to be regarded as a bad debt "is as a matter of substantial economic reality a loss of risk capital" (248 F. 2d 399, 406), it will be disallowed.

The term "substantial economic reality" is merely a way of expressing the fact that the determiantion whether the funds advanced are to be regarded as a "capital contribution" or "loan" must be made in the light of all the facts of the particular case. Rarely should any one element be determinative. See *John Kelley Co.* v. *Commissioner*, 326 U. S. 521, where the court said at page 530, "There is no one characteristic * * * which can be said to be decisive in the determination of whether the obligations are risk investments in the corporation or debts." See also, *Gooding Amusement Co.* v. *Commissioner of Int. Rev.*, 6 Cir., 1956, 236 F. 2d 159, cert. den. 352 U. S. 1031; *Earle* v. *W. J. Jones & Son*, 9 Cir., 1952, 200 F. 2d 846; *Brinker* v. *United States*, D. C. N. D. Cal. 1953, 116 F. Supp. 294, affirmed *per curiam*, 9 Cir., 1955, 221 F. 2d 478. Nor does the answer depend upon the taxpayer's motive. *Gregory* v. *Helvering*, *supra*. A brief review of the salient facts demonstrates the soundness of the Tax Court's decision.

Upon graduation from college, in 1930, petitioner Benjamin D. Gilbert showed talents as a salesman and promoter which he continued to exhibit during the next twenty years. In 1940, after a series of jobs covering a wide range of business activities, he alone, or with a partner, commenced to organize, or become interested in, a number of small companies, which engaged in the manufacture of mimeograph duplicators, wooden products, abode bricks, pocket stoves, a rubber latex spray, and experimental and production tools and dies for war use. Benjamin's other interests were the Perfect Oven Company, the Vacuum Concrete Corporation, and Gilbor, Inc., to which he made the advances in question. After its formation, Gilbor, Inc., acquired by purchase stock of the Oven and the Concrete companies. Turned Woods, Inc. was organized as a sub-

sidiary and Beaver Wood Products Co. (in financial difficulties) and Integrated Wood Products, Inc. were acquired. These companies required funds for their operation and development which they received from Gilbor, Inc. Throughout the years 1946 through 1948 Benjamin, his wife, Madeline, and his business associate, Albert Borden, made substantial advances to Gilbor, Inc. In view of the nature of the companies in which Gilbor, Inc. was interested, petitioner must have known that the chances of repayment would be very slim unless the various controlled companies prospered. The advances to Gilbor, Inc. were made during a period in which interest on prior "loans" was in default, the principal was unpaid and the corporation was insolvent, and they were used primarily for working capital and the purchase of capital assets.

Considering: (1) Benjamin's business background which must have acquainted him with the capital needs of his various ventures and the real possibility that his advances might well be swallowed up by Gilbor's capital requirements; (2) the attempt to keep the Gilbert-Borden advances closely proportionate to their stockholdings; and (3) the continued "loans" to a company which obviously was in serious financial difficulty and could not be expected to repay unless there were a substantial improvement in its financial affairs, it cannot be said that Benjamin has sustained the burden of proof which he must bear in showing that the Tax Court's decision is erroneous.

Petitioner's argument that the Tax Court arrived at three different and inconsistent results in treating Benjamin's advances as capital contributions, his wife's advances as non-business bad debts and Albert Borden's advances as business bad debts is not persuasive because each person had a sufficiently different relationship with Gilbor, Inc. to justify these conclusions.

The decision that the advances made by petitioner Benjamin were capital contributions and not debts within the meaning of section 23(k) of the Internal Revenue Code of 1939 obviates the necessity of passing upon respondent's contention that if the advances were debts they were non-business debts.

The decision of the Tax Court is affirmed.

APPENDIX F

UNITED STATES COURT OF APPEALS, SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the fourteenth day of January, one thousand nine hundred and fifty-nine.

Present: Hon. Carroll C. Hincks, Hon. J. Edward Lumbard, Hon. Leonard P. Moore, Circuit Judges.

Benjamin D. Gilbert and Madeline P. Gilbert, *Petitioners*,

v.

Commissioner of Internal Revenue, *Respondent*.

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. Daniel Fusaro,
Clerk.

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